

# ICPS newsletter<sup>®</sup>

## CEA integration benefits Ukraine only during the first stage

*Ukraine will benefit from the creation of a free trade area within the Common Economic Area (CEA), but further integration in the form of a customs or economic union will lead to economic and political damage. Meanwhile, Moscow is interested in deeper integration, which means establishing a common currency. Russia will suffer substantial losses from the creation of an FTA. Final judgement as to the benefits and losses for the Ukrainian economy resulting from integration will be possible only after additional agreements to the framework Agreement Establishing of a Common Economic Area are ratified*

An important foreign policy event in the second half of April was the ratification of the Agreement Establishing a Common Economic Area by the legislatures of Belarus, Kazakhstan, Russia and Ukraine. As agreed by the presidents of these countries, the CEA has been drafted as an economic union, which means participating countries will pursue a common economic policy (see Table 1). At the same time, Russia is looking for the deepest form of economic integration, a monetary union in which the participants will use a common currency.

### Free trade within the CEA would be convenient for Ukraine

According to ICPS, Ukraine can benefit from creating a free trade area (FTA) with Russia, Belarus and Kazakhstan, but deeper integration would inflict net losses on the Ukrainian economy. The advantages to Ukraine from setting up an FTA include:

- increased exports to participating countries, with the most notable impact being in trade with Russia, Ukraine's biggest trade partner. Primarily, exports of agricultural

commodities, foodstuffs and ferrous metals, which have the greatest number of exemptions in the current "free trade" regime, stand to increase. However, there is a risk that, even after the import and export duties are cancelled in mutual trade, some countries will continue to launch a great number of anti-dumping and special investigations, which would cancel out any liberalization of tariffs;

- reduced production costs for Ukrainian exports, thanks to cheaper imported raw materials and increased economies of scale as a result of access to bigger markets;
- higher competition among the manufacturers of the four countries will boost the performance of Ukraine's economy.

### Ukraine stands to lose from any further integration

Deeper, rapid integration among the four countries will have considerable negative impact on Ukraine's economy:

**CUSTOMS UNION.** We consider it very unlikely that the CEA countries will agree to adopt Ukrainian customs tariffs. This

means that Ukraine will have to redo all its bilateral agreements on access to goods and services markets with members of the Working Group of the World Trade Organization (WTO). This will considerably delay that negotiation process, and Ukraine will be likely to enjoy the advantages of WTO membership at a much later date. If the need arises to raise specific import duty rates, these agreements will be more complicated to review. Furthermore, raising new trade barriers with countries who are not CEA members will re-orient consumers and producers towards imports from CEA countries, where production is less efficient. As a result, the efficiency of resource allocation in Ukraine's economy will fall.

**ECONOMIC UNION.** A common economic policy would essentially require that a common government be set up, to take into account the interests of all participants of the economic union in formulating policy. However, there is a significant risk that economic policy in the CEA will be imposed by the most influential player, Russia. That is the case with the Eurasian Economic Association, where Russia has the right of veto on all decisions, and where, for the most part, Russian norms are applied to the other participants. Under these conditions, Ukraine will be unable to bring its economic policy and legislation in line with EU norms.

**MONETARY UNION.** Should CEA reject the notion of a new currency and choose the Russian ruble as their common currency—which is in contrast to all existing currency unions—this could result in a situation where Russia will determine the monetary policy of all CEA participants and enjoy seigniorage. Moreover, since the economic development of CEA participants is uneven, the absence of independent monetary policy will mean the countries

*Table 1. Stages of economic integration*

|                 |   |
|-----------------|---|
| Free trade area | Participating countries eliminate mutual trade barriers |
| Customs union   | Internal FTA + common external trade barriers           |
| Common market   | Customs union + free movement of capital and labor      |
| Economic union  | Common market + common economic policy                  |
| Monetary union  | Economic union + common currency                        |

will have difficulty fighting problems related to unsynchronized business cycles. As EU experience shows, laying down the conditions for transition to a single currency is a very lengthy process: the formation of the European Monetary Union took several decades.

## The CEA should cancel CIS-based trade barriers

The establishment of an FTA is a basic condition for the CEA. A free trade area involving CEA participating countries was already declared within the framework of an FTA among the CIS countries. It operates today, albeit with numerous exceptions. Setting up an FTA under the CEA seems to imply abolishing all those barriers.

The biggest number of trade exceptions are in favor of Russia. Specifically, the Russian Federation restricts imports of piping from Ukraine through quotas and regularly raises duty rates for imports of zinc-covered rolled metal from Ukraine and Kazakhstan. In addition, Russia charges VAT on gas and oil exports. In its turn, Ukraine limits imports of Russian automobiles and cement. Mutual trade barriers among CEA participants also affect farm commodities and processed food—in particular, confectionery products, sugar, spirits, and tobacco products.

Since the export profile of these countries is similar, setting up an FTA within the framework of the CEA should increase competition in certain key export sectors—in particular, agricultural commodities, steel products, machinery and equipment, and vehicles. At the same time, the participants' markets will also expand.

## Not all CEA participants will gain from an FTA

Assuming that the CEA-based FTA functions without any barriers, a number of potential implications for other participating countries can be predicted:

**RUSSIA.** Energy resources constitute the overwhelming majority of Russian exports to Ukraine and Belarus. This means that Russia will lose significant budget revenues if it drops the VAT on energy exports. Moreover, if energy prices in

Ukraine and Russia become relatively equal, the production cost of Ukrainian goods will be lower than that of similar goods produced in Russia, due to lower labor costs in Ukraine. As a result, Russian metalworks and manufacturers of farm equipment and food products will suffer the most

**KAZAKHSTAN.** Kazakh exports to CEA participants are dominated by mineral products and grains, while finished products occupy a larger share of its imports from participants. Kazakhstan's domestic market is limited and, what is more, huge transport costs create a major hurdle for the development of trade with European countries. An FTA would partly compensate for limited access to those markets. Kazakhstan will benefit from market diversification, especially once restrictions on rolled steel imports to Russia are dropped. As an energy supplier, however, Kazakhstan will lose out.

**BELARUS.** More than a half of Belarus's foreign trade is with Russia, as foreign trade between the two countries has developed within the framework of a customs union since 1996. Given the few trade restrictions between Belarus and other CEA participants, a CEA-based FTA will not have much impact.

## Ukraine—beware!

The risk of setting up a CEA-based FTA is that an upswing in trade within this FTA will make EU markets seem less attractive. After all, trading within the common area will be less problematic than fighting for European markets. This threatens to bring with it a certain isolation from developed EU countries, which would be intolerable for Ukraine,

particularly in the context of its aspirations to further European integration.

Setting up an FTA within the CEA could expand the markets of participating countries and at least partly offset losses from the closure of European markets. Nevertheless, given what it stands to lose from such a move, Russia is highly unlikely to really drop all its trade barriers, which Ukraine has been insisting on during negotiations.

The production cost of Ukrainian goods is unlikely to change, since the leveling of energy prices within the CEA is most likely to happen because other participants will raise their prices to Ukrainian levels, which are still way below world prices. Still, this leveling of energy prices could offer Ukrainian producers an opportunity to finance additional spending to upgrade their technology. However, they will have few incentives to do so, if they can continue selling their products on the undemanding CEA market even without modernization.

The positive consequences of an FTA will be dampened by the fact that foreign direct investments from within the CEA will bring fewer new technologies and know-how than those from economically-developed Western countries. At the same time, the removal of trade barriers between Ukraine and Russia alongside a more favorable investment climate in Russia could strengthen that country's competitive edge in attracting foreign investment.

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*Table 2. Foreign trade structure of CEA participants in 2002, %*

|            | Share of foreign trade turnover with: |            |        |         |    |
|------------|---------------------------------------|------------|--------|---------|----|
|            | Belarus                               | Kazakhstan | Russia | Ukraine | EU |
| Belarus    | –                                     | 0          | 57     | 3       | 19 |
| Kazakhstan | 0                                     | –          | 25     | 3       | 19 |
| Russia     | 7                                     | 3          | –      | 6       | 36 |
| Ukraine    | 2                                     | 2          | 29     | –       | 22 |

Source: Statistics Agency of the Kazakh Republic, State Customs Committee of the Russian Federation, Derzhkomstat of Ukraine, Ministry of Statistics and Analysis of the Republic of Belarus

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